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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In **the** Matter of Application by SBC Communications Inc., Pacific Bell Telephone Company, **and** southwestern Bell Communications Services, Inc. for Provision of In-Region, InterLATA Services in California	)))))))	WC Docket No. **02-306**

REPLY AFFIDAVIT OF CAROL A. CHAPMAN

REGARDING WHOLESALE PROVISIONING OF ADVANCED SERVICES

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I, CAROL A. CHAPMAN, being of lawful age and duly sworn upon my oath, do hereby depose and state as follows:

INTRODUCTION

1. My name is Carol A. Chapman. I am the same Carol A. Chapman who previously filed an affidavit (App. A Tab **3)** in this docket.

2. In this reply affidavit, I will address comments filed by AT&T Corporation ("AT&T") relating to line splitting, and to comments filed by XO California, Inc. ("XO) relating to line sharing.

AT&T'S COMMENTS

3. AT&T makes a number of claims regarding combination-related issues in its comments. I will address the portion of those comments relating to line splitting.[1]

4. AT&T admits that Pacific's current procedure for separating an existing UNE-P into the separate loop and port elements necessary to facilitate line splitting "take[s] an extremely short amount of time and creates no appreciable service disruption."[2] Clearly, therefore, the processes that Pacific has implemented to facilitate this activity are working well.

5. However, AT&T goes on to claim that Pacific is proposing new procedures where it would no longer coordinate the loop and port orders as it does today. AT&T's claim is simply false.

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1 *See* AT&T **Brief** at 31-32; Declaration of **Eva** Fettig (attached thereto) ¶¶ **14-15,** ***Application of SBC Communications Inc., Pacific Bell Telephone Company,*** *and* ***Southwestern Bell Communications Services, h c . for Provision of In-Region, InterLATA Services in California.*** WC Docket No. 02-306 (**FCC** tiled Oct. 9, 2002).

2 *See* Declaration of **Eva** Fettig ¶ **14.**

6. To begin with, line splitting arrangements are not a Pacific-provided "combination." Rather, in a line splitting arrangement, Pacific is not providing a combined product offering. Instead, Pacific is providing a stand-alone loop and a stand-alone switch port with transport to a CLEC's collocation arrangement. The actual "combining" of the elements physically occurs within the CLEC's collocation arrangement via the CLEC's splitter. Nonetheless, as Ms. Fettig of AT&T indicates, Pacific does allow the splitter to be pre-wired so that the CLEC does not have to perform any physical work in the central office in order to achieve connectivity at the time the elements are provisioned. Contrary to AT&T's claims, though, Pacific is not proposing to change its current processes for handling UNE-P to line splitting scenarios, but instead plans to continue to coordinate the stand-alone loop and stand-alone port orders in the same expeditious manner that Ms. Fettig herself praises.

XO'S COMMENTS

7. XO has commented on Pacific's processes associated with instances where a CLEC wishes to port a telephone number via local number portability ("LNP") when the telephone number in question is currently being provisioned over a loop that Pacific is sharing with a data CLEC in a line sharing arrangement.[3] Specifically, XO has alleged that Pacific has failed to satisfy Checklist Item 11, Number Portability, because "Pacific has refused to port numbers in a timely and efficient manner where migrating customers purchase both voice and DSL service

[3] ***See Comments* of** XO **California, Inc. at 22-24, *Application of SBC Communications Inc., Pacific Bell Telephone Company, and Southwestern Bell Communications Services, Inc. for Provision of In-Region, InterLATA Services* in *California*, *WC*** Docket No. 02-306 ***(FCC*** filed *Oct.* **9,2002).**

from SBC Pacific." See Comments of XO California at *22*. XO raised this same issue in its comments to the CPUC's proposed decision recommending approval of SBC's 271 application. Therefore, I addressed this allegation in paragraph 90 of my initial affidavit, and now address it further.

8. At the outset, XO describes the situation as one where Pacific provides the end user's voice ***and*** *DSL service,* and XO wins the voice. **As** matter of clarification, Pacific does not provide DSL service. Pacific simply sells the HFPL UNE over which a data CLEC may provision DSL. **ASI,** Pacific's separate advanced services affiliate, provides wholesale DSL transport service to Internet service providers in Pacific's local service areas in California.[4] The processes and practices that I described in my initial affidavit, and this reply affidavit, are applicable to affiliated and non-affiliated data CLECs alike.

9. Contrary to XO's assertion, the issue has nothing to do with "number portability" (*i.e.*, Pacific's willingness to port a telephone number, or its timeliness in doing so). Rather, the issue involves how Pacific accounts for the data CLEC's rights with respect to a line-shared loop when a voice CLEC (*e.g.*, XO) seeks to use that same loop to provide voice service to the customer. More specifically, XO appears to complain about how Pacific accounts for the data CLECs' rights when the voice CLEC seeks to use the same loop to provide facilities-based voice service but (a) has no agreement with the data CLEC to share the loop in a line splitting arrangement, and (b) has no desire to serve the voice customer over a

[4] ***See*** **Affidavit of John S.** Habeeb ¶¶ **15-17,** ***Application of SBC Communications Inc., Pacific Bell Telephone Company, and Southwestern Bell Communications Services, Inc. for Provision of In-Region, InterLATA Services in California,*** WC **Docket** No. 02-306 (FCC tiled Sept. *20,2002).*

different loop. As I explained in my initial affidavit, Pacific's policy and practice in this situation is that the voice CLEC may submit an "LNP with loop" request to Pacific; however, before Pacific can process such a request it must first receive and process an HFPL disconnect order from the data CLEC that is leasing the HFPL from Pacific. This policy and practice protects the data CLEC's rights under the ***Line Sharing Order,*** which provides that the data CLEC has the option of purchasing the entire loop when the customer terminates his or her ILEC voice service on a line shared loop "for whatever reason."[5] Furthermore, under Pacific's policy and practice, the end user (not Pacific) is responsible for contacting his or her Internet service provider (or, as the case may be, the data CLEC) to terminate, or arrange to have terminated, his or her DSL Internet service, and thereby free up the loop for conversion to the voice CLEC. This process ensures that neither the voice service nor the data service will be terminated without the end user customer's knowledge or permission![6]

10. I would also note that I have surveyed our account teams and Pacific regulatory groups. Based on this survey, it does not appear that XO raised this issue to Pacific prior to filing its comments to the California proposed decision on August 12 of this year.

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[5] ***See Deployment of Wireline Services Offering Advanced Telecommunications Capability and Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,*** Third Report and Order in CC Docket No. 98-147, Fourth Report and Order in CC Docket No. 96-98, 14 FCC Rcd 20912, ¶ 72 (1999).

[6] For example, if Pacific's policy were to simply disconnect the HFPL upon receipt of a loop with LNP order, the end user's data service could be terminated without the end user's knowledge or permission. Involving the end user in this process ensures that the end user is aware that changing voice providers in this instance could result in the disconnection of his or her data service.

11. In sum, the issue raised by XO has nothing to do with Pacific's willingness to port the number. Instead, the issue is solely related to determining whether the data CLEC will continue to utilize the existing loop when another CLEC acquires the voice customer.

CONCLUSION

12. Pacific provides CLECs with non-discriminatory access to xDSL-capable loops, the HFPL UNE, enables CLECs to engage in line splitting, and ensures CLECs have a meaningful opportunity to compete. The few issues raised by the CLECs in this proceeding in this area are baseless and should be dismissed.

13. Pursuant to Part II. E. of the Consent Decree entered into between SBC Communications Inc. and the Federal Communications Commission, released on May **28,2002,** see Order, In the Matter of SBC Communications, Inc., 17 FCC Rcd. 10780(2002), **I** hereby affirm that I have (1) received the training SBC is obligated to provide to all SBC FCC Representatives; (2) reviewed and understand the SBC Compliance Guidelines; **(3)** signed an acknowledgment of my training and review and understanding of the Guidelines; and (4) complied with the requirements of the SBC Compliance Guidelines.

14. This concludes my affidavit.

STATE OF **TEXAS**)
)
COUNTY OF **DALLAS**)

I declare under penalty of perjury that the foregoing is true and correct.

Executed on Oct 31, 2002.

Carol A. Chapman

Subscribed and sworn to before me this 31st day of October, 2002.

Notary Public

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Application by SBC Communications Inc.,	)	
Pacific Bell Telephone Company, and	)	WC Docket No. 02-306
Southwestern Bell Communications Services,	)	
Inc. for Provision of In-Region, InterLATA	)	
Services in California	)	

DECLARATION OF ROBERT W. CRANDALL

INTRODUCTION

1. I have been asked by SBC Communications, Inc. to respond to the allegations by DirecTV Broadband, Inc., PacWest Telecom, Inc., *et al.*, XO California, Inc., Ernest Communications, Inc., and MPower Communications Corp. that they face a "price squeeze'' in various services in California due to the structure of SBC's tariffed retail rates in California. Although I understand that SBC disputes a number of the facts on which these commenters base their allegations, for my purposes I accept these facts as true. Yet even so, the allegations are theoretically flawed: each runs directly contrary to the fundamental point that a price squeeze cannot succeed in a competitive market.

QUALIFICATIONS

2. My professional qualifications for submitting this expert report are as follows.

3. My name is Robert W. Crandall. I am the chairman of Criterion Economics and Senior Fellow in Economic Studies at the Brookings Institution in Washington, a position that I have held since 1978. My areas of economic research are antitrust, telecommunications, the automobile industry, competitiveness, deregulation, environmental policy, industrial organization, industrial policy, mergers, regulation, and the steel industry.

4. I have written widely on telecommunications policy, the economics of broadcasting, and the economics of cable television. I am the author or co-author of five books on communications policy published by the Brookings Institution since 1989.[1] In addition, I have

1. ROBERT W. CRANDALL & LEONARD WAVERMAN, WHO PAYS FOR UNIVERSAL SERVICE? WHEN TELEPHONE SUBSIDIES BECOME TRANSPARENT (Brookings Institution 2000); ROBERT W. CRANDALL & LEONARD WAVERMAN, TALK IS CHEAP: THE PROMISE OF REGULATORY REFORM IN NORTH AMERICAN TELECOMMUNICATIONS **(Brookings**

published four other books on regulation and industrial organization with the Brookings Institution.' My scholarship has been cited on numerous occasions by the federal judiciary and the Federal Communications Commission ("FCC").

5. I have been a consultant on regulatory and antitrust matters to the Antitrust Division of the U.S. Department of Justice, to the Federal Trade Commission, to the Canadian Competition Bureau, and to numerous companies in the telecommunications, cable television, broadcasting, newspaper publishing, automobile, and steel industries. I have also been a consultant to the Environmental Protection Agency and the U.S. Department of the Treasury. In 1992 and 1996, I served as a consultant for the Joint Sports Claimants ("JSC") in the cable royalty distribution proceedings. From 2000 through the present, I served as a consultant for Microsoft Corporation in the remedy phase of its antitrust litigation against the U.S. government.

6. I was an Assistant Professor and Associate Professor of Economics at the Massachusetts Institute of Technology between 1966 and 1974. **I** also taught at George Washington University. I have twice served in the federal government. **I** was Acting Director, Deputy Director, and Assistant Director of the Council on Wage and Price Stability in the Executive Office of the President. In 1974-75, I was an adviser to Commissioner Glen **O.** Robinson of the FCC.

(Footnote 1 Continued)
Institution 1996); ROBERT W. CRANDALL & HAROLD FURCHTGOTT-ROTH, CABLE TV REGULATION OR COMPETITION? (Brookings Institution 1996); ROBERT W. CRANDALL, AFTER THE BREAKUP: U.S. TELECOMMUNICATIONS IN A MORE COMPETITIVE ERA (Brookings Institution 1991); ROBERT W. CRANDALL & KENNETH FLAMM, CHANGING THE RULES: TECHNOLOGICAL CHANGE, INTERNATIONAL COMPETITION, AND REGULATION IN COMMUNICATIONS (Brookings Institution 1989).

2. ROBERT W. CRANDALL & PIETRO S. NIVOLA, THE EXTRA MILE: RETHINKING ENERGY POLICY **FOR** AUTOMOTIVE TRANSPORTATION (Brookings Institution 1995); ROBERT W. CRANDALL, MANUFACTURING ON THE Move (Brookings Institution 1993); ROBERT W. CRANDALL & DONALD F. BARNETT, UP FROM ASHES: THE U.S. MINIMILL STEEL INDUSTRY (Brookings Institution 1986); ROBERT W. CRANDALL, HOWARD K. GRUENSPECHT, THEODORE E. KEELER & LESTER B. LAVE, REGULATING THE AUTOMOBILE (Brookings Institution 1986).

7. I received an A.B. (1962) from the University of Cincinnati and a Ph.D. in Economics (1968) from Northwestern University.

8. I file this declaration in my individual capacity and not on behalf of the Brookings Institution, which does not take institutional positions with respect to specific legislation, litigation, or regulatory proceedings.

SUMMARY OF CONCLUSIONS

9. In Part I, I show that commenters' allegations of a price squeeze in this proceeding are theoretically implausible. The three product markets associated with the services identified by these complaints are highly competitive, and therefore are not fertile ground for a predatory strategy.

10. In Part II, I explain that one of the reasons for competition in heretofore regulated monopoly markets is to allow market forces to drive rates toward costs. Entrants must find the over-priced regulated services of the incumbents and attack those markets while avoiding the markets in which regulated rates are "subsidized' for universal-service reasons. Eventually, regulators will have to allow the latter rates to rise to reflect costs, but they should not do so simply to accommodate a complaining entrant.

11. Were the California Public Utilities Commission to accede to such complaints and adjust wholesale and retail rates as demanded by these companies, they would essentially be establishing wholesale-retail margins to allow inefficient competitors to thrive.

I. THE PRODUCT MARKETS IN WHICH SBC SUPPLIES THE IDENTIFIED SERVICES ARE NOT CONDUCIVE TO PREDATORY BEHAVIOR

12. The allegation that SBC is engaging in "price squeezes" against its competitors in California requires very specific information on the prices and incremental costs of delivering the relevant services.' For a given regulated wholesale price of UNEs, the average retail price of the relevant services must be sufficient to cover SBC's marginal cost, over and above the cost of the UNE, of providing the service. If the retail price exceeds the wholesale price by this margin, there is no price squeeze. The relevant test is not whether this margin over the UNE rate is sufficient to cover the costs of the companies complaining about a "price squeeze," but rather whether it is sufficient to cover SBC's incremental costs.

13. Because certain of the retail service rates addressed in the complaints of "price squeezes" are regulated rates, these retail rates often bear little relationship to costs. Some rates may be far above costs while others may be below cost. These rate disparities are often justified as necessary to provide "universal service.'' Competition should eventually force the California Public Utility Commission (CPUC) to rebalance these rates, but the existing regulated rate

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3. A central question in antitrust jurisprudence and scholarship is whether, as a theoretical matter, predatory pricing is a rational strategy for a firm to undertake. A related question is whether, as an empirical matter, predatory pricing ever actually occurs. ***See,*** *e.g.*, Paul L. Joskow and Alvin K. Klevorick, ***A Framework for Analyzing Predatory Pricing Policy,*** 89 YALE L. J. 213 (1979) (proposing a two-tier test courts could use to evaluate predation claims); Oliver E. Williamson, ***Predatory Pricing: A Strategic and Welfare Analysis***, 87 YALE L. J. 284 (1977) (arguing that, when firm behavior is considered over time, predatory pricing is a viable strategy because predatory firms will be able to establish a credible predatory commitment, deter potential entrants, and recoup losses); Phillip E. Areeda and Donald F. Turner, ***Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88*** HARV. L. REV. 697 (1975) (concluding (1) that sales below reasonably anticipated short-run marginal costs or average variable costs should be deemed predatory pricing, and (2) that predatory pricing is unlikely to succeed or be tried because a predatory firm will not be able to recoup its losses in most cases). See also PHILLIP E. AREEDA AND HERBERT HOVENKAMP, ANTITRUST LAW: 1999 SUPPLEMENT 224–30 (Aspen 1999) (reporting recent judicial discussion of predatory pricing); JOHN R. LOTT JR., ARE PREDATORY COMMITMENTS CREDIBLE?: WHO SHOULD THE COURTS BELIEVE? (University of Chicago Press, 1999) (explaining that while predation by private enterprises is implausible, predation by public enterprises is not).

disparities do not reflect any attempt by SBC to engage in a "price squeeze." Indeed, the companies complaining of such "squeezes" in this proceeding are not complaining about the retail rates that are currently providing the source of funds for these universal-service subsidies, but rather the wholesale rates for inputs they wish to use to compete in the provision of the services at issue.

14. **If** the structure of California retail rates does not currently reflect the relative costs of the various services, it would be imprudent in the extreme for the CPUC to adjust wholesale rates so that entrants can obtain a competitive return in each and every service. The wholesale UNE rates should reflect SBC's cost of providing the wholesale element, including the "option value" of offering elements with large *sunk* costs to rivals on a month-to-month basis. These rates should not be adjusted downward simply to accommodate entry in any regulated service in California.

15. In many retail markets, SBC now faces substantial competition. Any attempt by regulators to force SBC to raise prices of these services to allow entrants an attractive margin over the relevant UNE rates will simply cripple SBC's ability to compete.

A. DSL Services

16. PacWest and DirecTV complain that SBC's monthly rate for DSL-based Internet access service in California has fallen to a level that is below SBC's wholesale rate for last-mile access and ATM transport, and that this relationship creates a price squeeze.[4] But SBC sells its broadband (DSL) service to end users in competition with cable companies, fixed wireless providers, **and** satellite services. Its retail prices reflect this competitive reality.

4. PacWest Comments **at** 26-29; DirectTV Comments at 4-7

17. It would be irrational for SBC to employ a "price squeeze" in its DSL-based Internet access services to disadvantage competitive services using its UNEs. Such a "squeeze," even if successful in discouraging DSL competition, could not drive the cable television companies and other facilities-based providers from the broadband Internet access market. These competitors would remain, depriving SBC of any ability to raise the price of its DSL service. The short-term revenues lost in a predatory "price squeeze" could never be recovered in future periods.

18. The complainants' prize-squeeze allegation crumbles without evidence of market power in the relevant product market—namely, the mass-market broadband Internet access market.[5] A firm without market power cannot raise prices in a profitable manner. By the Commission's own criteria, SBC has no market power in the market for broadband Internet access services. *First*, SBC's competitors have captured more than 65 percent of the market for mass-market broadband services.[6] ***Second,*** customers for broadband Internet access service have price-elastic demand. Econometric analysis and customer-level churn data suggest that SBC could not profitably raise prices.[7] ***Third,*** SBC's competitors have more than enough excess capacity to

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5. Competitive Impact Statement at 9, ***United States v. AT&T Corp.,*** Civil No. 00-CV-1176 (D.D.C. filed May 25, 2000) ("A relevant product market affected by [the AT&T/MediaOne] transaction is the market for aggregation, promotion, and distribution of broadband content and services."); Complaint, AOL, Inc. v. Time Warner, Inc., Docket No. C-3989 (FTC filed Dec. 14, 2000) at ¶ 21 ("The relevant product market in which to assess the effects of the proposed merger is the provision of residential broadband internet access service."); ***See*** Jerry A. Hausman, J. Gregory Sidak & Hal J. Singer, ***Cable Modems and DSL: Broadband Internet Access for Residential Customers,*** 91 AM. ECON. ASS'N PAPERS & PROC. 302 (2001) [hereinafter Hausman, Sidak & Singer, ***Cable Modems and DSL***]; Jerry A. Hausman, J. Gregory Sidak & Hal J. Singer, ***Residential Demand for Broadband Telecommunications and Consumer Access to Unaffiliated Internet Content Providers,*** 18 YALE J. ON REG. 129 (2001) [hereinafter Hausman, Sidak & Singer, ***Residential Demand for Broadband].***

6. ***See High-speed Services for Internet Access: Subscribership as of December 31, 2000,*** Industry Analysis Division, Common Carrier Bureau, FCC, Aug. 2001, at Table 6.

7. ***See, e.g.***, Robert W. Crandall, J. Gregory Sidak, and Hal J. Singer, ***The Empirical Case Against Asymmetric Regulation of Broadband Internet Access,*** BERKELEY TECH. L. J. (2002); Paul Rappoport, Don Kridel, Lester Taylor & Kevin Duffy-Demo, ***Residential Demand for Access to the Internet,*** University of Arizona Working Paper, Spring 2001, at Table 10; ***see also*** Paul Rappoport, Don Kridel & Lester Taylor, ***An Econometric Study of the Demand for Access to the Internet, in*** THE FUTURE OF THE TELECOMMUNICATIONS INDUSTRY: FORECASTING AND DEMAND ANALYSIS (D.G. Loomis & L. D. Taylor eds., Kluwer Academic Publishers 1999).

constrain SBC's pricing determinations.* In fact, cable operators alone could likely absorb more than a sufficient number of DSL subscribers to constrain SBC's pricing of broadband Internet access. ***Fourth,*** SBC does not have advantages over its competitors in terms of relative size, resources, or cost structure, certainly not advantages that could confer monopoly power.' Rather, it appears that SBC's competitors have significant cost and other advantages, including a much more favorable regulatory framework in which to operate.

19. Finally, the method by which SBC's internal transfers are booked is irrelevant to a price **squeeze** analysis. If an unaffiliated Internet service provider cannot afford to compete with SBC's Internet company, it should exit from the market. Consumers of retail high-speed Internet access will not suffer as a consequence, because SBC's retail prices will be disciplined by the prices established by the cable companies. Stated differently, regulators ought not to be focused on ensuring the ability of inefficient competitors to survive in a competitive marketplace.

B. Pay Telephones

20. Ernest Communications and MPower allege that SBC is offering rebates and discounts on its payphone lines to "aggregators" of payphone service in California that result in revenues per line that are substantially less than SBC's rates for UNEs that some entrants use to offer the same service." Even if true, these allegations do not support the conclusion that SBC is engaging in a "price squeeze." The only reasonable conclusion is that aggregators have negotiated substantial discounts from SBC. Were the CPUC to require that SBC keep its payphone rates high to these aggregators, it would simply force a more rapid retirement of SBC capital facilities.

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8. **Cable capacity statistics available at http://www.emarketer.com/analysis/broadband/ 050800_cable.html.**
9. ***See, e.g.*, JP MORGAN H&Q/MCKINSEY & COMPANY, BROADBAND 2001: A COMPREHENSIVE ANALYSIS OF DEMAND, SUPPLY, ECONOMICS, AND INDUSTRY DYNAMICS IN THE U.S. BROADBAND MARKET, Apr. 2, 2001, at Chart 45.**
10. **MPower Comments at 8-10; Ernest Comments at 2-4.**

21. The payphone business is in steep decline because of the dramatic rise of cellular wireless services. SBC and other providers are losing payphone business to wireless providers and thus have substantial excess capacity in pay telephone services. Several telecommunications analysts have pronounced the payphone industry dead. **A** 2000 survey of telecommunications operators by the FCC demonstrates that, after the FCC deregulated coin rates in 1997 and payphone prices moved into alignment with costs, payphone revenues declined by 12.5 percent from 1998 to 1999.[11] From 1996 through 2001, the number of payphones booths fell from 2.6 million to 2.1 million."

22. The sharp decline in demand bas forced some carriers to exit the industry. In February 2001, BellSouth announced its decision to exit the payphone business to "focus on its core broadband, Internet and digital **network** offerings, as well as domestic wireless data and voice business and Latin America."[13] BellSouth attributed its decision to withdraw from payphone services to "market trends in the payphone business which indicate that customers are opting for the new technology options provided, including wireless telephones and interactive pagers."[14]

23. In spite of the decline in demand, payphone operators raised their rates above the regulated (and unprofitable) 1997 rate. Qwest and SBC raised their rates to $0.50 per minute in May 2001 and July 2001, respectively.[15] The increase in rates was designed to offset declining volumes at each pay station, leading to further declines and the retirement of more pay stations.

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11. ***Telecommunications Industry Revenues: 1999.*** Industry Analysis Division, Common Camer Bureau, FCC, Sept. 25,2000, **at** Table *2.*

12. Bruce Meyerson, ***Hanging Up Pay Phone Exit May Leave Customers Without Service,*** BATON ROUGE ADVOC., Feb. 20,2001, at 1-C.

13. BellSouth Corp., BellSouth Announces Plans For Public Communications Unit, Company Press Release, Feb. 2, 2001.

14. *Id.*

15. Sanford Nowlin, ***San Antonio-Based Telecom Company to Increase Cost of Pay-Phone Call,*** **SAN** ANTONIO EXPRESS-NEWS, July 6,2001, at *1.

Eventually, the only payphones left will be those uniquely located to be able to generate enough calls at 50 cents per call

24. In this competitive environment, SBC could not rationally engage in a "price squeeze" against payphone rivals because it has no power to recoup the losses from such a strategy even if it drove some rivals from the market. Pay telephones are a dying business that is rapidly being replaced by ubiquitous personal wireless communications.[16] SBC would have no market power in payphone services even if it were the only seller of such services.

C. DSl/DS3 Services

25. XO California, Inc. alleges that Pacific Bell's UNE rates for DS1 and DS3 loops are substantially higher than Pacific Bell's DS1 and DS3 retail prices." Here too, however, the claim that this alleged relationship results in a price squeeze fails in light of the competition in the market. High-speed business services are now offered by a large number of competitors in the business districts of most metropolitan areas. Beginning with the Competitive Access Providers in the early 1990s and continuing with the new CLECs after the 1996 Act was passed, enormous amounts of fiber were buried under the major business corridors. As a result, SBC and other incumbent carriers now face aggressive competition from a large number of carriers in the market for high-speed services, such as DS1 and DS3.

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16. Deborah Méndez-Wilson, *Wireless Takes Bite Of Pay-Phone Biz,* WIRELESS WK., Feb. 13, 2001 ("Many industry insiders predict the trend [of declining payphone use] will continue as wireless penetration increases, thinning out the pay-phone business even more."); USA-PAYPHONES TOLLFREE, ENHANCED VOICE SERVICES, PAUL BUDDE COMMUNICATION, at § 1.3 (2000) (explaining that wireless services are "siphoning off calls from payphones"); Hope Yen, *As cell phones flourish, pay phones take a hif,* ASSOCIATED PRESS ST. & LOC. WIRE, Jan. 18,2000 (explaining that "wireless phone usage has had a defmite impact" on payphone revenues); *Payphone industry influx,* ASSOCIATED PRESS ST. & LOC. WIRE, May 21,2001 ("You can almost chart (the decline of pay phones) on a graph from the time cell-phone companies started offering unlimited minutes or large bundles of minutes."); Kenneth Aaron, *In Cellphone Age. Pay Phone Industry Looks for New Ways to Make Profit,* TIMES UNION, Feb. 15, 2001, at *1 (interview with industry analyst Jeff Kagan, who explained that cellular proliferation has contributed to the declining payphone call volume).

17. XO Comments at 32-33.

26. The result of this competition has been downward pressure on DS1 and **DS3** rates throughout the country, whether as "special access" circuits to inter-exchange carriers or DS1 and DS3 circuits to end users. SBC's California rates must respond to this competition.

27. Moreover, any contract rates that are offered by SBC, even if they are below the UNE rate per line for individual DSI or DS3 loops, are surely not a reflection of a price squeeze. SBC could not possibly use such a strategy to eliminate its rivals' fiber optic capacity even if its prices somehow drove these rivals into bankruptcy. The fiber capacity would remain to be used by successor companies to compete with SBC. Thus, SBC could never recapture its losses from an alleged "price **squeeze''** through subsequent rate increases.

28. The complainants' price squeeze allegation crumbles without evidence that SBC could exercise power over price. Where SBC uses high-capacity loops to compete in the larger business advanced services market,[18] SBC faces extensive competition. Indeed, SBC has a miniscule share of the larger business advanced services market in its region.[19] The Bell operating

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18. According to standard antitrust criteria, larger business advanced services constitute a product market. ***First,*** the services in this market appear to serve the same function from the customer's viewpoint — that is, transmitting data between computers and between networks **of** computers. ***See,*** *e.g.*, Mulitmedia Telecommunications Association, Investext Rpt. No. 7044818, Telecom-Market Review and Forecast '98 – Industry Report, Jan. 1, 1998, at *10. ***Second,*** larger-business customers view the services within this market as substitutes for each other. STRATECAST PARTNERS, ATM AND FRAME RELAY MARKET ASSESSMENT, DATA/INTERNET SERVICES GROWTH **STRATEGIES,** Sept. **2001,** at 16. *Third,* advanced-services providers view the services within this market as substitutes for one other. ***See,*** *e.g.*, ***Putting romance back in the data business; Company Business and Marketing,*** COMM. WK. INT'L., Feb. **5,** 2001, at 1. *Fourth,* the services within **this** market are generally priced in **a** similar manner. IDC, U.S. FRAME RELAY SERVICES: MARKET FORECAST AND ANALYSIS, 2000-2005, at Table 26 (2001) [hereinafter IDC FRAME RELAY STUDY]; IDC, ATM SERVICES MARKET SHARE AND ASSESSMENT, 2000-2005, at Table 21 **(2001)** [hereinafter IDC ATM STUDY].

19. The two primary services in **this** market are frame relay service and asynchronous transfer mode (ATM) service. SBC's in-region market share for frame relay is 15.2 percent. When one accounts for SBC's share of all business access lines, SBC's share of in-region frame-relay revenues falls to 11.1 percent. ***See*** IDC FRAME RELAY STUDY at 3; **SBC's** in-region market share for ATM is 14.0 percent. When one accounts for SBC's share of all business lines, SBC's share ***of*** in-region ATM revenues rises to 16.5 **percent.** IDC **ATM** STUDY at 3. Because the frame relay-market is roughly five times the size of the ATM market ($1.08 billion in ATM revenues across all carriers versus $6.32 billion in frame relay revenues across all carriers), and because SBC accounts for roughly 40 percent ***of*** all RBOC business lines, on a value-weighted basis, SBC's share of the packet-switching market **is** roughly 12 percent.

companies were never the dominant players in this market—the competitive access providers (CAPs) were the market leaders from the inception of the service. With respect to demand elasticity, the type of customer for those services—a large, sophisticated business—suggests that the demand is highly price elastic. Moreover, the competitive bidding process for customers ensures that existing customers are insulated from price increases through the duration of the contract. SBC's largest competitors—the big three IXCs—have sufficient capacity to absorb any customers who would substitute away from SBC in response to a price increase. Finally, SBC has no advantage over its rivals in the provision of larger business advanced services.

29. Likewise, where SBC uses high-capacity loops to provide traditional special access, it is also constrained in many geographic markets by mature competition. Where it is not so constrained, SBC remains subject to tariff regulation that would foreclose any attempt to recoup revenues foregone in the pursuit of a predatory strategy.

II. REGULATORILY IMPOSED ARBITRAGE WAS NEVER INTENDED TO BE PERMANENT

30. It is well established that mandatory unbundling creates opportunities for arbitrage. The logic of the arbitrage opportunity works as follows: if a CLEC could purchase the network element at long-run average incremental cost (LRAIC), and if it could turn around and sell that element to a former ILEC customer at a price slightly less than the retail price, then the CLEC could earn an initial margin of $r - e - c$, where r is the retail price of the service, e is the smallest pricing decrement, and c is the cost of the network element.

31. What is the long-run equilibrium of this pricing game between a CLEC and an ILEC? If the ILEC does not match the CLEC's price of $r - e$, then the ILEC will begin to lose more and more customers to the CLEC. Hence, the ILEC must respond with a price equal to $r - 2e$. The

CLEC will then respond with a price equal to $r - 3e$. This process continues until end-user prices fall to c, a point at which neither the CLEC nor the ILEC earn a positive margin.

32. The above pricing example shows that UNE-based entry by CLECs should force the ILEC's margins to zero. When viewed in this context, SBC is doing exactly what the regulators should expect when it lowers its retail price.

33. The same result could be achieved by compelling the ILECs to price their retail services at LRAIC. (Because it would have upset the massive cross-subsidy scheme built into pricing of local services, however, the direct redistribution method would never have received the necessary votes in Congress.) This direct redistribution method would transfer 100 percent of the ILEC producer surplus directly to consumers. The indirect redistribution method—mandatory unbundling—distributes ***temporarily*** a percentage of the ILEC producer surplus to a few competitors.

34. Whatever the merits of this approach as a method for introducing competition into the local exchange, the objective of the unbundling regime could not have been to establish ***permanent*** margins for CLECs—there is no long-run equilibrium that supports positive margins for CLECs offering traditional telecom services with unbundled elements. But that is exactly what the commenters in this proceeding are now seeking. Like any arbitrage opportunity, the unbundling regime cannot ensure positive margins for the CLECs forever. Under the "efficient market hypothesis" of telecommunications regulation, as soon as the network element becomes publicly available at LRAIC, the retail price will adjust to LRAIC. Stated differently, as the ILECs react with lower prices of their own, or as additional CLECs enter, the arbitrage opportunity is eventually eliminated.

CONCLUSION

35. The start-up costs of entry and the economies of density in telecommunications are substantial. No entrant can expect to cover its costs *ab **initio*** unless regulated retail rates are kept artificially high, or UNEs are drastically under-priced relative to appropriately measured costs. In addition, there are substantial joint costs in telecommunications, making it difficult for any carrier to cover its costs from a narrow service offering.

36. The complaints filed by the competitive carriers in this proceeding address the margins that are available to them in competitive service markets after they pay the regulated price for UNEs. By definition, such markets do not lend themselves to a price squeeze.

I **declare under** penalty of **perjury that** the **foregoing is** true **and correct.**

Executed on November 1, 2002.

Robert W. Crandall